Mizuho Flash: SVB & Risks

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Note from the Road: SVB & How to Think About Risks

In a Nutshell: While the SVB shock and attendant risks could send UST yields lower on "risk off" and recession fears, risk premium is likely to rise as markets re-assess under-priced risks in the context of tighter global policies, compromised fiscal position and a coincidence of high-volatile inflation amid heightened Geo-political risks.

Moreover, it is **presumptuous to conclude that the Fed will suspend, if not reverse, rate tightening on financial risks implied by SVB**; as timely action to backstop bank run risks and the BTFP to circumvent a wider blowout of asset-liability mismatch help de-couple monetary policy from financial risks.

Near-term yields and rates could remain highly volatile as hard-landing risks are perceived to be accentuated by tightly linked financial and real economic risks emerging; with SVB seen as just one of many possible manifestations.

Risk Free Rates and Risk Premiums

1) The SVB shock that sent UST yields reeling lower amid "risk off" and bets on Fed pivot may see yet more two-way volatility in rates, yields and wider markets. But in a world of higher and volatile rates, it is important to make the distinction between risk-free rate and risk premium.

2) To that end, it is our well-telegraphed view that while 2022 was a year of rising risk-free rates, 2023 **looks set to be the year of rising risk premium; even as bets mount on peak Fed rates/Fed pivot.**

3) And the SVB saga only reinforces this view as the conspiracy of pressures from tighter global monetary policy, compromised fiscal positions and higher inflation accentuated by heightened uncertainty amid Geo-political risks set the stage to recalibrate risk appetite.

4) To be sure, this is not just due to episodes of eruptions in financial risks shaking down valuations (driving up risk premium), but rather, precisely because of the Fed's ability to backstop risks.

5) Point being, this means that the **Fed is likely to deem financial sector/banking risks sufficiently mitigated for it to continue measured tightening; defying expectations of panicked suspension (or even reversal) of its current tightening path**.

6) As a result of which, the conditions for continued, and possibly more emphatic, flight to quality are likely to prevail.

7) What this means is that even if risk aversion and/or recession risks drive UST yields (risk free rates) lower, risk premium is set to rise; in a mechanism of differentiated tightening in conditions that adjusts for risks appropriately.

8) In policy speak, the sudden spike in financial conditions from SVB will be dealt with as **a stand-alone, idiosyncratic event, that could be ring-fenced with specific non-rate response.** Whereas, the trend of (calibrated) tightening in financial conditions need (and most likely will) not be abandoned; much less thrown into reverse gear. At the very least, it appears that hopes for a Fed pivot from SVB triggers appear overblown.

9) While it is still in the early days, the Fed's immediate response has encouraging promise of ring-fencing financial stress/contagion by simultaneously;

i) quelling distress by guaranteeing all deposits, insured or not, and;
ii) dampening doubt about echoes of SVB elsewhere in the financial system by establishing Banks Term Funding Program (BTFP), which allows banks to borrow using USTs as collateral at full face value (arresting liquidity run that may turn into a solvency crisis)

10) In turn, and crucially, this will de-couple SVB risk mitigation and response from wider monetary policy; as risk re-pricing stops short of uncontrolled economic devastation and/or excessive tightening in financial conditions.

11) Admittedly, flight to quality amid risk repricing involves some degree of tightening in financial conditions. But arguably, some of this is intended, and as such will not prematurely setback Fed hawks. Crucially, so long as a disorderly blow out in risk aversion is averted, **Fed hawks may not roll over on SVB trigger alone.**

12) Received wisdom, and attendant worries, about the Fed not stopping "until something breaks" may thus remain intact; as SVB alone may not suspend Fed tightening. In fact, SVB may be but one manifestation of wider financial sector risks unleashed. In the meantime, volatility- latent and realised - being rendered far more acute is par for the course.

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